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ABSTRACT

Federal tax policy could affect employment policy through the following four provisions: the Targeted Jobs Tax Credit (TJTC), employment incentives in enterprise zone legislation, individual training accounts (ITAs), and employer reimbursement of employee educational expenses. The TJTC and enterprise zone proposals are both attempts to cause certain persons or target groups to achieve more employment than they would in the absence of the program. Because the plans are unlikely to create many new jobs for the economy as a whole, gains by the target populations will be roughly equaled by losses of other groups; however, the losers will never be able to identify themselves. The ITA approach, on the other hand, could take many forms, some of which would be heavily dependent upon employer funding and some of which would be similar to the Individual Retirement Account (IRA) program. Comparable objectives could also be achieved with a direct expenditure, such as government-run training programs or vouchers for persons identified as displaced workers. Because the enterprise zone, TJTC, and ITA proposals all involve using the tax system to achieve objectives that could also be achieved through direct public expenditure, the nation pays a price for all three programs in the equity, simplicity, and enforceability of its taxes for tax expenditures. In addition, the special benefits that these three proposals extend to special groups distort the tax system relative to more neutral forms of taxes. (MN)

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THE ROLE OF FEDERAL TAX POLICY IN EMPLOYMENT POLICY

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THE ROLE OF FEDERAL TAX POLICY IN EMPLOYMENT POLICY

Introduction: Most government promotion of employment and training activities is financed by government spending. But governments can also use their tax systems to encourage the private sector to achieve public objectives such as hiring the disadvantaged and providing training. The targeted jobs tax credit (TJTC) is an example at the federal level. Some states use their tax system for employment-related activities in enterprise zone legislation and tax credits for expanding employment. Use of the tax system to stimulate activity through government spending creates what is known as "tax expenditures."

The National Governors' Association is addressing a range of issues involving federal tax policy. The employment-related tax expenditures need to be considered in the context of both appropriate tax policy and employment policy. The subjects for consideration are: (1) the targeted jobs tax credit (TJTC), (2) employment incentives in enterprise zone legislation, (3) individual training accounts, and (4) employer reimbursement of employee educational expenses. This paper provides background information for NGA's Committee on Human Resources and Committee on Economic Development and Technological Innovation.

BACKGROUND: THE TAX SYSTEM AND EMPLOYMENT

Introduction: From time to time, statements are made that the federal tax system favors or discriminates against labor as distinct from capital. Before considering individual tax expenditure proposals, it is important to understand how federal taxes affect employment generally. This perspective is also useful in appraising proposals for broadening the corporate and individual tax bases to make it possible to lower tax rates.

The Current Corporate Income Tax: Statutory and Effective Rates: The business tax system is based upon taxing a substantial percentage of net income, 46% for most corporations. Conceptually, net income is what is left after a corporation uses its gross receipts to pay its expenses. This approach allows deduction of all business expenses, including payments of labor and capital costs. Retained earnings and the dividend payments to stockholders are made with after-tax dollars. In concept, the system clearly doesn't discriminate against labor or borrowed funds but does, some argue, discriminate against equity financing.

However, income as defined in current federal tax law deviates considerably from a pure income concept and from what corporations report to their stockholders as income. While one would expect corporations to pay about 46% of their income in federal income tax, they actually pay as federal taxes about 16% of what they report to their stockholders as before-tax income. The differences arise from some exotic causes (e.g., loss carryforwards and foreign tax credits), but primarily are caused by the tax treatment of capital investments.

The Investment Credit: Major tangible investments (e.g., machinery, rail cars) are provided with an investment credit which effectively reduces taxes by a little less than 10% (of the cost of the investment) for purchases of property expected to last more than five years. This credit is designed to encourage investment in capital assets and is clearly non-neutral with respect to labor costs. That is, one would expect more to be spent on labor and less on capital if the credit did not exist.

Depreciation: The most significant cause of the difference between the statutory income tax rate and what corporations actually pay is depreciation. Whether the depreciation rules are non-neutral between capital and labor cannot be decided without a concept of what appropriate depreciation rules should be.

The choices are best illuminated by example. Joe's Trucking begins with an investment by Joe of $10,000 which is used to buy a new truck. Joe takes in revenues of $30,000 and pays out $20,000 in expenses, primarily to pay his truckdriver. All the choices for treatment of capital in the tax system boil down to deciding how much Joe's Trucking made in its first year. The major choices are:

(1) **Immediate Expensing:** Under this theory, Joe made no money because he took in $30,000 in revenue and had $30,000 in costs, $20,000 in operating expenses and $10,000 for his truck. Under this treatment, Joe pays no federal income tax. This approach is advocated by some corporate spokespersons to encourage investment, but is not allowed in the U.S. tax system except for certain investments by small businesses.

(2) **Regular Depreciation:** Under standard accounting practices, Joe's trucking made money. It started the year with Joe's capital contribution of $10,000 and ended the year with $10,000 in cash and a truck worth, say, $9,000. Because the firm is $9,000 better off as a result of the year's operations, standard accounting practice would require that $9,000 in income be reported to stockholders.

To make income $9,000 rather than $10,000 or zero, a new category of expense must be recognized. This is called depreciation. There is little controversy over whether corporations should be allowed eventually to treat all of the costs of capital investments in property as expenses which reduce taxes. The arguments are over when this expense is recognized.

In regular depreciation, the expense is conceptually the loss of value of the asset that occurred during the year. For trucks, this is an easy calculation because there is a ready market for used trucks. However, there is no easy way to value steel plants and other business assets every year and such valuations might show wild gyrations, so rules of thumb are used to calculate depreciation. These rules determine how long the asset is predicted to last (useful life) and the relationship of depreciation in the early years to depreciation in the later years (e.g., 125% declining balance, straight line, sum of the years' digits).

(3) **Accelerated Depreciation:** Accelerated depreciation bunches more of the deductible expenses in the earlier years of asset holding and less in the later years than would be the case if regular depreciation were used. Some form of accelerated depreciation has been in the U.S. tax code for decades, but the Accelerated Cost Recovery System adopted in 1981 speeded depreciation even more. The rationale was that faster depreciation would encourage investment in plant and equipment that would enhance worker productivity and economic growth.

Because money today is more valuable than the same amount several years later, accelerated depreciation is considered a tax expenditure.

(4) **Inflation-Adjusted Depreciation:** Both immediate expensing and regular depreciation allow total capital outlay to be taken as a deduction eventually. However, in an inflationary world, this is not normally enough to replace the asset. In the example, if Joe spends all the company's after-tax income and wears out the truck, he will find himself with assets of only his $10,000 of initial capital. This will likely not be enough to buy a new truck at then-prevailing prices. To avoid this problem, some argue that depreciation should be based on what it would take to replace the asset, which is normally more than what it cost.

Inflation-adjusted depreciation is not allowed for in calculating U.S. or state taxes and is not used by companies in their income statements except in the form of a special analysis required by the Securities and Exchange Commission. The recent Treasury Department tax reform proposals do embody the concept.

All corporate payments for labor and human capital (e.g., training programs) can be expensed -- the most favorable tax treatment possible short of special incentives such as tax credits. To determine whether depreciation favors capital at the expense of labor requires selection of one of the depreciation treatments listed above as the appropriate one. If expensing is selected, the treatment of labor is comparable to that of capital. If some other concept is picked, then any concept with a higher number in the list than the concept selected has a bias toward capital.

The Broader Issue of Tax Treatment of Human Capital: It is also possible to examine the total U.S. tax system to determine whether there is a bias against human capital, that is the accumulation of knowledge and experience by individuals. There is no problem involved when the employer pays training and work-related education costs, as these are deductible expenses of the employer and do not affect the taxes of the employee. However, when individuals pay their own costs, the situation changes.

Much of the cost of the development of human capital is paid for by governments in the form of free public education, subsidized higher education, and publicly provided adult education and worker training. However, what an individual pays as higher education tuition, private school tuition, and tuition to training programs in such fields as computer programming and word processing are not deductible expenses for the individual. This treatment is not parallel to taxation of physical capital. Investments in physical capital designed to increase income are eventually recovered by depreciation by individual investors and by corporations. But individuals are not allowed a deductible expense to recover their costs for professional education. However, the capital stock represented by professional skill of individuals is not subject to the state and local property taxes but physical capital is reached by these taxes.

EMPLOYER PAYMENTS OF EMPLOYEE EDUCATIONAL EXPENSE

The Issue: When an employee or self-employed professional undergoes training that is designed to maintain existing skills or to meet requirements for maintaining a license to practice a profession, or is required by an employer to continue in a job, the costs of that training are deductible for someone. If the employer pays, the employer deducts the cost as a business expense and there is no tax consequence for the employee. If the employee pays, the amounts can be deducted from income and income tax thereby reduced.

A different situation arises, however, when the training is not required to maintain the existing job. If a computer programmer goes to medical school or a doctor to classes in English literature, the expenses clearly are not deductible if the individual worker pays them. They are clearly not required to maintain the worker's existing job. Tax-writing professionals generally aim for parallel treatment of any expenses, regardless of who pays them. Thus, they argue that to be consistent these costs should be considered personal consumption regardless of who pays them. This means that if the employer pays them, their cost should be included in the employee's taxable income. Educational institutions, labor organizations, and companies paying for education of employees typically argue against this approach.

Federal policy on this subject is basically unsettled because it is part of the larger issue of taxation of fringe benefits. For some time, these payments were deductible to the employer and did not create taxable income for the employee. As is often the case with controversial provisions, this special treatment had a sunset provision which caused it to expire at the end of 1983. The Senate version of the Deficit Reduction Act of 1984 would have extended this provision through 1984 and 1985; the House version would not have done anything; the conference agreement was to do nothing. However, legislation passed separately late in the 1984 session extended the exclusion through 1985.

The Arguments Against Non-Taxable Employee Benefits: The Treasury argument against the provision is part of a general fear of the consequences of non-taxable fringe benefits. The tax that is paid on an added dollar of earnings is quite steep. In 1984, raising the wages of a single worker making $26,000 by $100 would result in additional federal income tax of $30, additional Social Security tax (FICA) of $7.00, and additional state and local income taxes (which depend upon location) of about $5. It would also cause an increase of $7 in the employer's FICA contribution. As a result, a $100 raise costs the employer $107 and nets the employee $58, with governments getting the rest. To get $100 after taxes to this employee, the employer must raise pay by $172 and then pay employer FICA on that amount, making the total tab $184. Thus, employers often face a situation in which they must spend from $150 to over $200 to put $100 of after-tax purchasing power in the hands of employees.

This mathematics gives employee organizations and employers strong and mutual incentives to provide for everything possible in the form of employee fringe benefits rather than salaries and wages. The predictable result is movement toward full payment of employee health care costs, non-contributory private pension plans, employer-paid life insurance, employer payment of worker and dependents' educational expenses, employee discounts on merchandise or services, conventions that also provide family vacation opportunities, employer provision of transportation to work, free employee

parking, employer provision of day care, employer provided diet counselors, health spas, dental plans, lawyer plans, financial counselor plans, etc. The "cafeteria plan" is a way to recognize how close to personal consumption these items are by letting individual employees choose the mix of benefits they want.

Treasury has chosen not to take a position on the merits of these items; it is not opposed to medicine, dentistry, law, education, health care, or insurance. However, Treasury tends to oppose all situations in which employee consumption is paid in pre-tax dollars. Its arguments are:

(1) **Revenue Loss:** The revenue loss from non-taxable fringes is massive and growing. Leaving employer-paid health care alone out of the tax base will cost $20 billion in FY 1985, up from $15 billion in FY 1983. In addition, the Social Security system loses Medicare and retirement fund income.

(2) **Equity Among Similarly Situated Individuals:** Two neighbors may be identical in all respects except that one gets tax-free benefits and the other pays his or her own medical, legal, dental and other bills. They will pay equal federal income tax even though one's income is effectively several thousand dollars higher than the other's.

(3) **Effect on the Progressivity of the Tax System:** The most significant beneficiaries of fringe benefits will be self-employed professionals. IRS rules prevent a large organization from providing larger benefits to high salaried employees than other ones, but an incorporated professional may pay massive benefits to all employees of which there may be but one.

In addition, low wage occupations tend to have no fringe benefits, while they are common in higher wage ones.

The Arguments for Non-Taxable Employee Benefits: One argument made for not taxing employee benefits like health care and education is that this policy encourages the private sector to assume a large share of the costs of such services. If the employer did not assume these costs, it is argued, some of them would have to be borne by government. Encouraging private financing can also be seen as an economically and politically feasible route to public policy results, such as universal health insurance, that are unlikely to be reached by more direct routes.

Attempts to limit tax-free benefits are also opposed by the firms that supply the tax-free items and/or those who believe in their usefulness. Thus, health-care providers like employee health plans, life insurance companies like dental insurance, restaurant owners and workers like unlimited allowances for business meals and beverages, and educators like employer-sponsored education plans.

Limits on tax-free benefits can also disrupt collectively bargained agreements which presumed non-taxability of benefits.

The argument for non-taxability of employer-provided education that is not work-related is comparable to the arguments for other benefits such as health care. If education is good and more education will be consumed if the benefit is nontaxable,

then having it be non-taxable is good. Critics argue that even if society wants to spend the amount of the revenue loss for education, it could do so more effectively by programs that spend the same money but are more targeted to those in financial need and/or courses of study more carefully selected than some of those supported by employer education programs.

The education issue is likely to be around for a while. Employer-paid expenses for education and training to improve employees' ability to do existing jobs will probably always be non-taxable to employees. But employer payment for other educational costs is one of the benefits that Treasury seeks to tax in its modified flat tax proposal.

INDIVIDUAL TRAINING ACCOUNTS

The Displaced Worker Problem: The recent recession highlighted the problems of displacement that have been caused by trade, technology, and other changes in our economy. Generally, "displaced workers" had high-paying factory jobs which they had held for some years, have families, were often the sole source of family support, had substantial financial commitments from mortgages and consumer credit, and did not appear to have either geographic or occupational mobility. They lost jobs in industries such as farm equipment, autos, and steel -- with little or no apparent prospect for reemployment with their former employer or elsewhere in their industries.

There has been considerable debate over how many workers were "displaced," stemming from differences over definitions of what constitutes displacement. The numbers in use for displaced workers range from 100,000 to three million. With no agreement over past numbers, it is not surprising that estimates of the magnitude of future displacement problems also show substantial variation.

For considering eligibility for a possible new tax credit program oriented to displaced workers, it is difficult to define displacement much more tightly than involuntary unemployment of persons not likely to be called back to their last job. This definition would include essentially all unemployed persons with previous jobs excepting seasonal workers and those laid off with call back probable. During the past recession, this definition would yield a number approaching 5-8 million workers. Tightening the definition of displaced workers to concentrate on declining industries and/or occupations yields much smaller numbers, some as low as 100,000 for the past recession.

Some displaced workers will solve their own problem without public intervention. Some can retire early; some can find satisfactory jobs in other occupations; some have substantial assets or other income sources and can afford their own training. Others will not accept the usual policy proposed for them, retraining, even if it is offered free. Some have such close ties to their communities that they will stay even if there is no reasonable expectation of finding work.

The response to this problem to date has been a title of the Job Training Partnership Act dealing with displaced workers and alterations to unemployment compensation rules to make it easier for UI recipients to be involved in training programs while receiving compensation. In addition, collective bargaining agreements in industries such as communications and auto and truck manufacturing have been adopted

to deal with the problem with provisions for retraining, relocation, and job search assistance.

The Concept of Individual Training Accounts: One approach suggested for dealing with displaced workers is the establishment of individual training accounts (ITAs). The concept is comparable to the IRA and employer contributions for pension plans. Individuals could establish separate accounts capitalized with their contributions. Those contributions would work as dollar-for-dollar reductions in taxable income just as IRAs do. Earnings in the designated account would be tax-free. It would also be possible (in some versions, required) for the employer to match employee contributions or even to make contributions that would eliminate the need for employee contributions. Funds could be withdrawn for retraining and, depending on how the proposal is structured, for certain other purposes such as acquiring a business, and meeting costs that were met with income when the individual was employed.

This same IRA-like approach has been suggested for savings designed to meet dependents' future educational expenses and for saving intended to finance employee purchase of a first home.

Voluntary Employee Plans: In considering these proposals, it is important to assess just who would participate and why in any voluntary employee contributions. Even with the tax reduction associated with reducing income by the amount of contributions, the ITAs would represent individual savings. But many Americans simply do not save money over and above the automatic savings associated with Social Security and employer-funded pension plans and principal payments on mortgages.

Not surprisingly, the non-savers are concentrated in lower income groups. However, one would not expect high participation in such plans by younger factory workers who have taken on the obligations of a new family and often a new mortgage as well as consumer credit from such things as cars, boats, and recreational vehicles. These individuals often feel they "can't afford" to save. From an outside perspective, this decision not to save is not irrational in many cases. Normally, income would rise at least with inflation while obligations associated with children would drop to zero and, before retirement, the home mortgage will be paid off. In addition, many of these workers can expect substantial capital infusions from deaths in their prior generation. While estimates of participation rates are all speculative, it is quite possible that voluntary plans would not draw the workers they are intended to protect.

These plans would draw the same persons who are the primary participants in IRAs. Like the IRA, these plans would have to make the principal available to the employee on retirement. At the time of employee retirement, the funds have no further purpose and fairness and the need to encourage participation would preclude any other alternative disposition of employee contributions. As a result, they will be appealing to older workers who often have more ability to save and more willingness to tie up their funds until their retirement age. Having to delay access to funds until age 59.5 is a significant restriction for someone aged 21, but much less so for someone at age 50. Thus one would expect use of the accounts to be disproportionate among those whose income exceeds their needs — primarily higher income persons — and older persons.

These problems are generally recognized, so there does not appear to be serious consideration of a truly voluntary ITA. Instead two other approaches have been proposed: (1) expanding permitted uses of IRAs and (2) a mandatory ITA.

Expanding Permitted Uses of IRAs: The existing IRA program allows annual contributions of up to $2,000 for an active worker and $250 for a spouse who is not working. There is considerable sentiment for increasing both these contribution limits. The IRA contribution is taken as a deduction from income and the earnings in the IRA account are not taxed until withdrawn by the employee. Unpenalized withdrawals cannot be made until the employee becomes disabled or reaches age 59 and a half. Withdrawals can, however, be made at any time. Premature withdrawals result in a penalty tax of 10% of the withdrawal. In addition, all withdrawals are counted as income and thus subject to tax.

Use of IRAs is expanding rapidly as an increasing number of Americans recognize the value of the vehicle for saving funds to be used before retirement. For a worker in the 22% tax bracket (a single worker making roughly $15,000 and subject to a 4% marginal rate from state and local taxes), the break-even point for use of an IRA for savings for major expenses (e.g., a home downpayment, college education for children) is seven years if 10% can be earned on the investment. That is, more money will be available (after both income taxes and the penalty) from use of an IRA than from regular savings. For higher income taxpayers the IRA break-even point is even earlier than seven years. It is also earlier if a rate above 10% can be earned. As savings against a contingency of involuntary unemployment, the IRA is even more valuable because the taxpayer's marginal federal tax rate would be low (or zero) in the year of withdrawal.

One obvious way to achieve the presumed benefits of the ITA is to allow IRA withdrawals to meet the training needs of the unemployed without the penalty and without taxing the amount withdrawn and used for training as regular income. This is exactly the approach taken in H.R. 4832 introduced by Representative Johnson (R-Conn.) in the last Congressional session. Enactment would presumably provide even more encouragement for persons to make IRA contributions and reduce the need for public sector spending on retraining of unemployed workers. The costs in lost federal revenue would result from: (1) the losses resulting from any additional contributions stimulated by the program and (2) the very limited losses resulting from loss of penalty and regular tax income from amounts withdrawn and used for training.

Mandatory or Quasi-Mandatory ITAs: Another approach is to make the ITAs either mandatory or to provide such strong incentives for participation or such harsh penalties for not participating that the program is mandatory in fact if not in law. This is the approach taken in H.R. 4832 introduced last session by Representative Durbin (D-Ill.). States would be encouraged to participate because they would basically lose administrative funds for their unemployment insurance programs if they failed to offer an ITA option. Employers would strongly be encouraged to participate because their tax deduction for employer contributions would be 125% of the contributions and they would be subject to a special tax of about $14 per year per employee if they did not.

Participating employees would contribute the lesser of 0.8% of wages or $250 and employers would match the contribution. The employee contribution would reduce taxable income. The states (as agents of the Secretary of Labor) would accept the

contributions and maintain accounts for each employee, covering the administrative costs out of the contributions. Employer and employee contributions would stop when the account total reached $4,000. Unemployed workers could use amounts in their account for retraining and relocation. If workers had not yet accumulated the $4,000 or a lesser amount needed for their training, it would be financed out of an insurance pool also created by deductions from the contributions. Employees get their unused money back on retirement. Employers get unused money back when the employee leaves their employment voluntarily by quitting or retiring.

Employer groups have many objections to this proposal. They are concerned over cost, suggest a lack of need, and feel the availability of the accounts in the event of unemployment will encourage unemployment and worker turnover. Some labor organizations also have reservations. Proponents see the plan as an excellent way to finance worker retraining.

Using Earmarked Savings or Insurance: Becoming a "displaced worker" is a contingency that could affect practically all workers, but it is one that most probably consider unlikely to happen to them. It is, however, a contingency for which most would like to have financial coverage. The ways in which such situations are typically handled are: (1) general savings available for all contingencies for which savings are useful and (2) purchase of insurance or government programs (e.g., means-tested entitlements) which function like insurance by providing financing only in the event of certain adverse contingencies.

In broad sweep, the ITA issue reflects this choice. IRA funds can already be used, with a penalty, for the needs of displaced workers. One proposal is simply to improve the usefulness of the IRAs by making them more readily available for these training needs. The contrasting approach is to use direct appropriations for training, which could be done out of general federal revenues (as in JTPA) or out of proceeds of a special training tax administered through the unemployment insurance system or some mixture of the two. The ITA proposal introduced in the last Congress resolves these choices in a complex and administratively costly way, but the economic choices are clear.

If one assumes that the incentives of an ITA would cause every employer to adopt it, the proposal would raise 0.8% of the nation's wage and salary bill in the first year, or about $15 billion. These funds would be raised by a payroll tax with the same characteristics as the Social Security payroll tax including equal employer and employee contributions and regressivity because no tax is paid on income in excess of $31,250 because of the $250 maximum. Of the $15 billion:

- $1.5 billion would go to the insurance pool to fund retraining benefits which exceeded worker savings.
- An unspecified amount would be used for administrative costs of employers (unreimbursed), states and the federal government. If $20.00 per year per account is the right number for maintaining each account — it is an educated guess — then $2 billion would be used for this purpose.
- The remainder would represent forced savings of employees and employers with accounts earning interest at the federal interest rate.

It is not clear that all of this activity and administrative cost is required to achieve the intended results. The alternative is simply to use general taxes for whatever portion of worker retraining society feels should be paid from those taxes and a special surtax in the unemployment compensation system for whatever portion society feels should be paid by payroll taxes. IRA incentives could be used to minimize the first two by encouraging workers to save and making it easy for them to retrieve those savings to deal with problems they encounter as dislocated workers.

TARGETED JOBS TAX CREDITS

The Current Program: The concept of the TJTC is to encourage the hiring of persons in a target group by giving employers tax breaks that are not available when hiring workers not in the target group. The detailed program design questions include defining the target group, determining the form of the subsidy (e.g., credit or extra deduction), determining the duration of the subsidy, deciding on the depth of the subsidy, determining whether it applies to all jobs and industries, and deciding on rules (if any) to prevent displacement of employment and churning of jobs.

The present TJTC provides for nine target groups:

- Vocational rehabilitation referrals,
- Economically disadvantaged youth,
- Economically disadvantaged Vietnam-era veterans,
- Supplemental Security Income recipients,
- General assistance recipients,
- Economically disadvantaged youth participating in cooperative education programs,
- Economically disadvantaged ex-convicts,
- AFDC recipients and WIN registrants, and
- Economically disadvantaged summer youth employees.

Figures released by the U.S. Department of Labor for FY 1983 reveal over a 100% increase in the issuance of certifications from FY 1982. In FY 1983, youth accounted for 60% of the certifications issued and AFDC recipients for almost 12%. The credit generally is 50% of the first $6,000 wages paid in the first year of employment and 25% of wages paid in the second year of employment. For summer youth employees, however, the credit is equal to 85% of up to $3,000 of wages for a maximum credit of $2,550.

Many employers do not use the credit for a variety of reasons. First, the subsidy is less deep than it might seem because the tax-deductions for wages paid are reduced by the credit. From an employer perspective, there is substantial paperwork involved as the

eligible potential employee must obtain what amounts to a provisional certification which the employer uses to get a final eligibility certification. For potential employees, there is concern over possible "stigma" associated with being eligible, so employees may not volunteer their eligibility in interviews. For employers, there are potential employee relations and discrimination problems associated with asking questions about past incarceration or welfare dependency. It has been estimated that less than 5% of employers take advantage of the program.

In the Deficit Reduction Act of 1984, the Congress extended the credit for one year, so under current law it will apply to employment begun before the end of 1985. Thus, the issue of further extension for 1986 and beyond will be before the Congress this year.

Analysis of TJTC: However a TJTC is designed, it will have certain features inherent in the concept. First, there will have to be a paperwork process whereby someone (usually not the employer) certifies that a potential employee is in the target group. Second, the subsidy will be paid in situations in which the employer would have hired persons from the target group with or without the subsidy. Third, so long as the subsidy is not massive and special training programs are not provided, the firms getting the subsidies will be those which would be expected to hire persons like target group members. If the target group is welfare recipients, for example, the jobs will tend to be low-skill, low-wage ones.

TJTC is an attempt to achieve social policy objectives through the tax system. This fact gives it a predictable set of proponents and opponents. Proponents will be those who would advocate the same subsidy as a direct expenditure but feel that it is easier to get society to adopt the policy through the tax system. Proponents will also be those who feel implementing a program through the tax system inherently has less administrative cost than implementation through government-administered expenditures, although the need for a public sector certification of eligibility reduces somewhat the strength of this argument.

Opponents will include those who oppose the policy as either a tax expenditure or regular expenditure. These would be those who don't want to subsidize the target group on principle (e.g., it is discriminatory to do so) or because of the perceived impacts on the employment prospects of persons not in the target group. In addition, those concerned with the tax system will worry about revenue effects, complicating the tax compliance and enforcement functions, and seeking to avoid periodic review of social policy by packaging costs in the tax system rather than expenditures.

Viewing the issue from the perspective of the governors mirrors these same issues.

Tax Policy: NGA's attention has been drawn toward tax policy as a result of major Congressional tax reform proposals and by the emphasis the Administration may place on tax revision. In the area of corporate taxes, the overriding issue is whether to conform corporate taxable income more closely to an economic view of what income is in order to broaden the tax base and lower the rates. If NGA were to opt to support this move, it would still be possible, but more difficult, to support TJTC. The situation is directly analogous to supporting particular grant programs in a context of seeking a reduction in the deficit.

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Thus, positions on TJTC need to be considered in light of whatever overall position NGA takes on federal tax policy.

Trade-Offs with Other Programs: The process of review of tax expenditures and regular expenditures does not afford easy ways for those interested in employment and training to make trade-off decisions. It is quite likely that a decision by interested parties to forego the TJTC would not result in any increased federal funding for expenditures seeking to achieve essentially the same objectives. However, from a broader perspective, there is no free lunch. Revenues foregone from TJTC mean either less spending in other programs (including other tax expenditures), a larger deficit, or some combination of these effects.

Equity Effects: Although there is research progressing on this subject, it is difficult to determine accurately the extent to which TJTC causes employers to hire different persons than they otherwise would. However, if the program works, this must be the effect. While reducing the effective wage bill associated with certain low wage employees should also expand aggregate employment somewhat (e.g., if wage costs were cut to a dollar an hour employment would expand), this effect is likely relatively small and nearly impossible to demonstrate empirically.

The TJTC reduces the tax liabilities of firms which take advantage of it, which are primarily firms in the service sector. The benefits of this reduced liability in competitive industries will tend to be shifted to the consumer, but may to some degree be captured by workers and stockholders in the firms involved. The costs of providing these benefits depends on how one assumes they are financed -- by other taxpayers, by expenditures lower than they would otherwise be, or by deficits larger than they otherwise would be. It is likely that a mixture of these effects is involved, but there is inherently no way to make this determination empirically.

State Fiscal Effects: The FY 1985 revenue loss from TJTC was estimated by OMB to be about $730 million. States are not required to follow rules for the definition of corporate income set by the federal government, but many states do. If all states followed the federal rule the state and local (mostly state) revenues lost in FY 1985 would be about $280 million.

Insufficient data are available to judge the effects on state expenditure. When a welfare recipient gains employment that ends welfare and Medicaid eligibility, the state savings are substantial. However, for these gains to have resulted from TJTC, many conditions must have been met: (1) the job must result from TJTC; job gains that would have occurred without TJTC for which TJTC is claimed do not count, (2) if TJTC causes someone to get a job who otherwise wouldn't have it, there is somewhere a person who would have had the job but for TJTC -- if that person receives welfare and AFDC there is no net gain from TJTC, and (3) the person holding the job must lose AFDC and Medicaid eligibility -- if eligibility remains, the AFDC costs are cut but not eliminated and the Medicaid costs remain. Unless one is willing to assume that TJTC affects the total number of jobs in the economy, there is no net benefit to state tax revenues as revenues will be the same whether the job is held by someone in the target population or not.

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ENTERPRISE ZONES

The Reagan Administration has generally been opposed to programs that seek to promote the economic development of targeted local areas through federal spending. As a result, some programs have been eliminated. Others have been cut back and are expected to be attacked further (e.g., EDA and Farmers Home Administration development programs). Others have frozen funding but may come under attack in the FY 1986 budget (e.g., community development block grants and urban development action grants). However, the Administration does support targeted area development through the tax system by creation of enterprise zones. Current NGA policy supports implementation of this concept on a pilot basis with certain caveats relative to the role of the states. Some 20 states are already implementing enterprise zone programs of their own.

There are a variety of versions of the enterprise zone legislation. The Administration may revise its own proposals before they are resubmitted to the Congress in 1985 and, in light of the budget situation, there is some question about how hard it will push for enterprise zone enactment.

The latest serious consideration of enterprise zones was as a part of the Deficit Reduction Act of 1984. The Senate version of that legislation provided for the designation of 75 zones at a rate of 25 per year. Investments in the zone would result in additional investment credits; increases in payroll to qualified zone employees would result in a new 10% credit (effectively reducing this wage bill by 10% in the zones). There was also a special credit for hiring disadvantaged workers and zone workers would themselves receive a credit of five percent of their wages. Other tax advantages in the zones would include non-taxability of capital gains and the ability to use both industrial development bonds and accelerated depreciation, a combination prohibited to non-zone employers.

The effects of all these provisions can best be understood as an income effect and a substitution effect.

The income effect is that these provisions will give firms operating in enterprise zones lower costs. These effects will be magnified by the state and local tax concessions likely to be made in the same zones. The added after-tax income will go to (1) pay certain higher costs of operation in the zones such as crime prevention and transportation in some situations and (2) support some combination of lower costs for consumers, higher worker pay, and higher rewards to owners than would otherwise be the case. It is possible that the subsidies would be deep enough to cause jobs to exist that otherwise would not (or would exist abroad), but this effect likely will be limited.

The primary effect will be to substitute jobs in enterprise zones for jobs that would otherwise exist in other locations and, to a limited degree associated with the employment credit, to cause jobs to go to certain target persons rather than others.

The impacts on states are comparable to those of the TJTC. State revenues will be adversely affected by whatever federal tax concessions are reflected in state income taxes, plus the expenditures and tax expenditures the state decides to make on behalf of developing the designated zones. The positive effects on state revenues and costs depend on how the federal tax concessions are financed, the extent to which the

program takes people out of other state-financed programs, and the effects on those who would have had jobs but for the program.

The policy choices are also parallel to those in the TJTC. They include deciding on appropriate targets (in this case, place targets and people targets), picking the depth of the subsidy, and determining whether tax expenditures or direct expenditures are more appropriate means for dealing with the problems addressed by the policy.

CONCLUSION

Certain features of the federal tax system, particularly the investment credit and, as some see it, accelerated depreciation, are not totally neutral between capital and labor. These policies are the deliberate result of decisions to promote investment in physical capital in the name of economic growth and international competitiveness. These rationales are likely to continue to be powerful motivators of federal and state policies for taxing business enterprises. However, alternative tax approaches are available to make corporate taxation more neutral toward labor costs, with the current Treasury proposal providing a prime example.

The TJTC and enterprise zone proposals are both attempts to cause certain persons (target groups) to achieve more employment than they would in the absence of the program. These plans are unlikely to create many new jobs for the economy as a whole. As a result, gains by the target populations will be roughly equaled by losses of other groups, although the losers will never be able to identify themselves.

TJTC and enterprise zones buy an employer preference for target groups (and places in the case of the zones) by tax concessions. The gains initially accrue to the employer, offset by any additional administrative costs and higher real costs that may be associated with having target group employees and/or locations in enterprise zones. The gains left after these costs would appear to accrue to the owners of the firms who are the ones getting their taxes reduced. However, in our competitive economy many of these gains will likely be shifted to consumers in the form of lower prices — with an inherently unknowable portion of the gains being shared by workers and owners of the firms initially receiving the benefits.

The revenue losses to the federal Treasury will also have effects in some combination of causing taxes to be higher, other federal spending to be lower, or the deficit to be larger. There is no way to predict in advance, or determine after the fact, precisely which of these effects is involved in what proportion. However, the total effect must equal the revenue loss. Other things being equal, higher taxes and/or reduced spending tend to cause job loss in our economy, and many people believe higher deficits have the same effect. It is possible that TJTC and enterprise zones would cause some actual expansion of the economy by stimulating use of resources (e.g., labor) that would otherwise remain idle. However, it is also possible that the higher taxes and/or lower spending, and/or higher deficits would cause comparable loss of growth. Determining the balance empirically is simply not possible. Predicting the balance depends upon partially subjective evaluations of the impacts of the taxes and programs involved and more knowledge than is presently available on the impacts of TJTC and enterprise zones.

The ITA proposals take many forms, including some heavily dependent upon employer funding and some similar to IRAs. If a plan similar to IRAs is involved, it may be more appropriate and cheaper for tax administration and administration of the plans if non-penalizable uses of IRA funds are expanded to encompass the intended uses of the ITAs. To the extent that employer funding is involved, it may be more effective to extend the insurance principle already found in the unemployment insurance system than to establish a separate program to deal with a particular aspect of needs during unemployment – retraining. Comparable objectives could also be achieved with a direct expenditure, such as government-run training programs or vouchers for persons identified as displaced workers.

All three proposals – enterprise zones, TJTC, and ITAs -- involve tax expenditures, the use of the tax system to achieve objectives that could also be achieved through direct public expenditures. The nation pays a price in the equity, simplicity, and enforceability of its taxes for tax expenditures. In addition, tax expenditures provide special benefits to those who happen to be in the right position (e.g., already located in an enterprise zone, already inclined to draw on a labor pool of disadvantaged workers, already seeking to save for retraining). These special benefits distort the tax system relative to more neutral forms of taxes. However, tax expenditures have benefits including whatever benefits are associated with each of them and the general advantage of often having lower administrative costs than direct spending. Tax expenditures are generally subject to different and, some claim, less stringent review than spending. To proponents of the particular benefits involved, this is an advantage. To others it is a disadvantage.

It is likely that NGA will be called upon to take positions on a variety of tax policy matters that raise the general question of the extent to which the base of corporate and individual income taxes will be broadened by reducing or eliminating certain tax expenditures. Any positions taken on tax expenditures for employment and training should reflect the broader tax policy context. That context may allow room to support some tax expenditures including ones applicable to state and local governments directly (e.g., deductibility of state and local taxes) and some of concern to state officials because of their interaction with state programs such as enterprise zones and assistance to low-income persons.

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